

AGENDA ITEM 3b
FINANCIAL STATEMENT AUDIT MANAGEMENT LETTER COMMENTS
PRIOR YEAR REPORT WITH CURRENT YEAR UPDATES
AS OF SEPTEMBER 30, 2010

Audit (Report Issue Date): Report to Management for the Year Ended 06/30/07 (12/14/07)

Observation 14.1: Security Policies and Practices Forms

Division responsible: Information Security Office

Observation:

CalPERS policies state that all newly-hired employees will review the CalPERS Information Security Policies and Practices and sign an Information Systems Security and Confidentiality Acknowledgement (ISSACA) form. In addition, all current employees will review and re-sign the form yearly. The form states, among other items, that the employee agrees to abide by CalPERS information systems requirements including the understanding that:

- CalPERS information assets and computer resources are only for CalPERS approved purposes.
- Employees are to access CalPERS systems and networks using only my assigned user identifiers and passwords.

Employees are to notify the CalPERS Information Security Officer immediately of any actual or attempted security violations including unauthorized access; and, theft, destruction, or misuse of systems equipment, software, or data.

While CalPERS policy is that all new-hires complete and sign the ISSACA form and current employees re-sign the form yearly, we found that evidence of the signed forms are not always maintained. Our testing of 18 new-hire forms found that 17 percent could not be found. In addition, we tested six current ITSB employees and were only able to find four completed forms. The lack of available signed forms could indicate that either the employee did not complete the review and subsequently sign the form, or that the form had been misplaced. In either case, the evidence of completion of the form is not available putting the agency at increased risk for non-compliance to the information security policies and practices. CalPERS ISO (Information Security Office) should institute new procedures to ensure that training is provided and new-hires sign the ISSACA form. Periodic internal reviews should be accomplished to ensure this is being done. In addition, procedures should be implemented to ensure that recurring training is accomplished and the recurring ISSACA form is signed and submitted to the Human Resources Department.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. Information security training is now being delivered via the CalPERS Learning Management System (LMS). The training began March 3, 2010 and as of April 26, 2010, 70% of staff have completed the training. The LMS was procured as a part of the PSR project in order to track and deliver the training necessary to bring CalPERS staff up to speed with the new PSR system. In the last year or so since the LMS went live, it has been integrated into CalPERS as the way all training is scheduled and tracked by the CalPERS All Staff Training and Development (ASTD) section.

The information security training was created by Information Security Office staff, and it is used not only as training, but as a substitute for the paper copies of the ISSACA form. The last few screens of the training replicate the exact text of the ISSACA form, and the final question asks if the staff member agrees to abide by the CalPERS information systems security requirements covered in the course. If the staff member agrees, then they have

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met the requirement to sign the ISSACA form. That agreement is recorded by the LMS and it is reported to the Information Security Office. The LMS reports the staff members who have and who have not received the training and who have agreed to abide by the requirements.

Staff members are added to the LMS via a recurring file transfer from CalPERS' PeopleSoft HR system. This insures that all CalPERS staff are registered in the LMS, so that Information Security Office gets a report of all staff who have taken the training and agreed to the requirements.

Observation 15.3: Formal Authorization for User Access
Division responsible: Information Technology Services Branch

Observation:

CalPERS uses an in-house application, Movaris, to manage the workflow used to authorize user account access and authorizations to the various member benefits information systems; CRS, Comet, and RIBS. A review of the process, however, finds that the designated data owners or their formal designees as reported to the Information Security Office, are not required to provide formal authorization prior to a user being allowed access to the application or data. This has the potential to increase the risk associated with the disclosure or integrity of the data as the data owner is not the final approval authority granting access. The CalPERS ITSB should work to ensure that the Movaris application process includes procedures for the formal data owner or the data owner designee to provide approval prior to granting access to an application or data under the responsibility of the data owner. Current user application accounts should also be reviewed by formal data owners to ensure that all accounts currently in use have the proper approvals.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. To comply with the Information Security Office's "Identity Authentication Practice", data owner approval functionality has been included in the User Access Request System (UARS) for the COMET, RIBS and CRS applications.

The Information Technology Services Branch has also validated that all current COMET, RIBS and CRS application users have appropriate data owner authorizations. Any user accounts not approved or deemed no longer needed have been removed from the in-scope systems.

Observation 15.4: Shared User Accounts
Division responsible: Information Technology Services Branch

Observation:

Shared accounts are being used by the database administrators when accessing the Oracle database or the VSAM file environment. The use of these shared accounts creates a situation wherein actions taken within the database system cannot be tracked back to a specific individual. Inadvertent or malicious activity may not be able to be positively associated with a specific individual essentially eliminating an effective audit trail.

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CalPERS Information Technology Services Branch should evaluate the use of shared accounts and discontinue their use where it has been determined there is a risk to the database. Database administrator accounts with schema owner access should be controlled with access granted sparingly and only after proper approval has been granted.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. Information Technology Services Branch has completed a review of all non-human IDs with access to VSAM files as well as the Oracle schema owner accounts used by database administrators.

All non-human IDs with access to VSAM accounts have been brought into compliance with the Information Security Office's "Data Owners and Custodians" and "Identity Authentication" practices. Information Technology Services Branch identified two shared accounts with access to VSAM files and facilitated their approval with the appropriate data owners and the Information Security Office. This approval also constitutes the acceptance of risk of their use by both the data owners and Information Security Office.

Information Technology Services Branch also found the risks associated with CalPERS' use of shared Oracle schema owner accounts to have been previously accepted by both Information Technology Services Branch and Information Security Office under Information Security Office's Policy Variance 04-061 dated April 2, 2004.

Observation 15.5:	Schema Owner Access
Division responsible:	Information Security Office

Observation:

Database administrator with accounts to the Oracle database or the VSAM environments may potentially have the capability to alter member information affecting benefits payments. Tests have not been conducted to determine if the database systems have sufficient logging triggers or oversight such as file balancing or reconciliations to verify if unauthorized changes can be detected.

The CalPERS Information Security Office should conduct testing to determine if persons with schema owner access to the Oracle database or to the VSAM files can make changes to the database that would affect member benefits without detection.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. While database administrators with accounts to the Oracle database or the VSAM environments may be able to alter member information affecting benefits payments, there is a control managed within Member and Benefits Service Branch which reconciles all transaction changes affecting member benefits payments to the individual that made the change.

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The BMA054 report is run daily. This report reflects any adjustments to a member's allowance. The report is distributed daily to all supervisors and/or managers to review and sign off on any changes manually keyed by their staff. A master copy of the report is maintained for a year.

Each month a BMA069PI report is run. This report highlights cases which multiple updates to a member's benefits within the same month. The report is distributed monthly to all supervisors and/or managers to review and sign off on any changes made by their staff. A copy of the report is maintained for a year.

Should a database administrator make an unauthorized change to a member's benefits, it would be identified by this control.

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Observation 6: Analysis and Reconciliation – GASB 40 and AIM

Division responsible: Fiscal Services Division

Observation:

Our audit procedures revealed numerous errors and inconsistencies in the GASB 40 disclosures, as Fiscal Services did not independently verify whether the amounts provided by the custodian bank were accurate or in conformity with the provisions of GASB Statement No. 40. The original data provided by the custodian bank had a variance of approximately \$6 billion which was subsequently addressed and the appropriate data was included in the CalPERS financial statements.

We also discovered errors in the financial statement disclosure of unfunded alternative investment commitments. Certain amounts provided by CalPERS' third party service provider did not agree to information provided by the partners. Although the disclosed amounts were corrected, Fiscal Services did not independently corroborate the unfunded commitments in preparing the financial statement disclosure.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. Fiscal Services has implemented a process to ensure proper disclosure information is included for non-rated fixed income investments. In addition, Fiscal Services has completed reconciliation and analysis on the recently received June 30, 2010 debt securities file and the international securities file for the 2009/2010 CAFR footnote disclosure on interest risk, credit risk and foreign currency risk and submitted the information to Macias, Gini & O'Connell for review.

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Observation 8: Complete Disclosure of Contingent Losses

Division responsible: Fiscal Services Division

Observation:

We identified a contingent loss that was not properly disclosed in the draft financial statements. Current procedures are not sufficient to ensure that contingencies will be accrued or disclosed in accordance with GAAP.

We recommend that Fiscal Services meet with CalPERS' general counsel to identify pending litigation, claims and assessments in conjunction with the preparation of the annual financial statements and ensure all legal responses are included in the financial statements when appropriate.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. Fiscal Services has met with CalPERS general counsel to identify pending litigation, claims and assessments in conjunction with the preparation of the annual financial statements. Fiscal Services continued this effort and developed a process for logging and identifying contingent liabilities which will be implemented in 2010.

Observation 9: Management's Discussion and Analysis Improvements

Division responsible: Fiscal Services Division

Observation:

Management's discussion and analysis (MD&A) prepared by Fiscal Services meets the minimum GAAP requirements; however, we believe incorporating the unique perspectives of the managers responsible for key activities would enhance the usefulness and improve the users' understanding of the financial statements.

We recommend that Fiscal Services obtain narrative explanations of the significant changes in financial position and results of operation from management responsible for the related activities. Fiscal Services should be heavily involved in the analysis to ensure compliance with the financial reporting standards and to avoid redundancy in the MD&A.

Current Status:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. Fiscal Services continues to prepare separate Word documents of the CAFR MD&A for submission to appropriate program areas for feedback on suggested revisions. Fiscal Services, in consultation with program staff, will analyze the input to ensure compliance with the financial reporting standards and to avoid redundancy in the MD&A.

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Observation 13: Password Requirement Non-Compliance

Division responsible: Information Technology Services Branch

Observation:

We found that password requirements used to access the mainframe applications, RIBS and CRS, currently do not fully adhere to CalPERS' Information Security Identity Authentication Practice certain key areas. We recommend CalPERS' mainframe administrator update the Resource Access Control Facility (RACF) security settings to ensure that the settings comply with the Information Security Identity Authentication Practice. The Information Security Office should conduct periodic monitoring to ensure compliance.

Current Status:

IN PROGRESS. The recommendation is in the process of being implemented. With the development and implementation of PSR, it was decided that no further updates to the current legacy applications would take place. As a result, the password configuration requirements were not updated to be in compliance with the I.S. Identity Authentication Practice. This recommendation, however, will be addressed with the PSR system implementation and will replace the mainframe applications, RIBS and CRS. The target completion date is June 30, 2012.

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Observation 1: CERBTf Contributions and Distributions

Division responsible: Constituent Relations and Audit Services

Observation:

During our audit, we determined that premium payments made by participating employers outside of the CERBTf were not reported in the financial statements as required by generally accepted accounting principles (GAAP). The Governmental Accounting Standards Board recently provided clarification and guidance which requires the reporting of payments made outside of the trust as both contributions toward the annual required contribution and as distributions from the trust. For the fiscal year 2008-09, an audit adjustment of approximately \$228 million was recorded to reflect contributions and distributions made outside of the CERBTf as required by GAAP. Current policy allows employers to offset premium payments made outside of the trust against the employers' required contributions to the trust. The policy does not address how the employers should report those payments to the System. In fiscal year 2008-09, the CERBTf Compliance and Reporting Unit requested contribution and distribution information from all participating employers via email. However, responses were not received from all employers and the transactions originally were not reflected in the financial statements.

We recommend that CalPERS enhance policies and procedures to gather the contributions and distributions data from participating employers. In the limited instances in which the employers do not provide the requested data, CalPERS should develop a process to

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estimate premium payments made outside of the CERBTf. As part of the enhanced policy, CalPERS should consider requiring annual certification of the annual required contribution (ARC), premiums paid outside of the CERBTf and the net contribution made from all participating employers.

Fiscal Services should work with the Compliance and Reporting unit to record the transactions in the general ledger as they are reported to CalPERS by the employers. In addition, we recommend that the Office of Audit Services consider examining amounts reported by participating employers on a risk-based, periodic basis. The examination should be designed to determine that CERBTf disbursements reported by participating employers comply with the policies outlined in CalPERS' CERBTf Prefunding Plan.

Management's Response:

COMPLETE. Pending final verification by Macias, Gini & O'Connell. The CERBTf Compliance and Reporting Unit has enhanced policies and procedures to collect contributions and distributions from participating employers and reviewed the process with the auditors. The Compliance and Reporting unit will obtain annual certification of ARC premiums paid outside of the CERBTf and net contributions made from all participating employers.

The CERBTf Compliance and Reporting Unit and the Office of Audit Services concur and have met to develop a risk based approach to examine on a periodic basis if CERBTf employers comply with CalPERS policies outlined in the CERBTf Prefunding Plan.

Observation 2: CERBTf Actuarial Valuations

Division responsible: Audit Services

Observation:

Employers participating in the CERBTf engage third-party actuaries to perform other post-employment benefits (OPEB) valuations in accordance with the CalPERS *OPEB Assumption Model*. CalPERS actuaries review each valuation for compliance with the CalPERS OPEB Assumption Model; however, current procedures do not include an independent review of the underlying participant data used by the third-party actuaries. Errors in member data may distort valuation results and lead to improper determinations of actuarial accrued liabilities and annual required contributions.

We recommend that the Office of Audit Services perform risk-based, periodic tests of participant data used by the third-party actuaries. The tests should be designed to determine that participant data used in the actuarial valuations is consistent with the participating employers' official records.

Management's Response:

IN PROGRESS. Office of Audit Services agrees with the recommendation, and has worked with Constituent Relations to develop procedures to review participant data used in OPEB valuations provided by employers who participate in the

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CERBT. The procedures were completed as of June 30, 2010. A series of pilot reviews will start in late August 2010, with a target completion date of June 30, 2011.

Observation 3: Claims Processing
Division responsible: Health Benefits Branch

Observation:

CalPERS has contracted with third-party administrators to service the claims of its health plans and prescription drug program. Service agreements stipulate that claims must be submitted to the third-party administrators within 15 months and 12 months of the related service, for health plan claims and prescription drug claims, respectively. During our testing of HCF claim payments, we determined that claim submissions often represented services rendered beyond the time frame specified in the respective third-party service agreements.

We recommend that CalPERS evaluate whether the claim submission time frames established in the service agreements are reasonable based on the current operating environment. Service agreements should be enforced or revised accordingly. We further recommend that management, with the assistance of the service providers, determine whether procedures can be enhanced to improve the timeliness of claim submissions. Timely claim submissions are essential for CalPERS to manage its cash flows and ensure compliance with the service agreements.

Management's Response:

IN PROGRESS. The Health Benefits Branch has evaluated the claim submission time frames established in the service agreements and believes they are reasonable based on current operating environment. The audit findings included claims that fell within exception rules in the claims system. The contract language is being amended and upon approval and completion will be provided to close this finding. The target completion date is November 30, 2010.

Observation 4: Real Estate Appraisals
Division responsible: Investment Office

Observation:

Properties held in separate account real estate partnerships are valued based on third-party appraisals directed by CalPERS. Appraised values are adjusted by the general partner to reflect changes in fair value between the appraisal date and the end of CalPERS' financial reporting period. CalPERS' real estate Performance Monitoring Unit (PMU) is responsible for ensuring appraised property values are properly recorded by the partnerships in accordance with the CalPERS' Investment Policy for Real Estate Accounting. During our testing of real estate partnership investments, we noted the following:

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- The PMU faces significant challenges in performing the task of verifying that appraised values are being properly reflected in the partnerships' financial statements in a timely manner as there were approximately 1,600 individual properties appraised in fiscal year 2008-09 and only one staff was assigned to perform this function.
- Certain general partners report to CalPERS at the aggregate or fund level rather than the individual property level. In some instances, it was difficult to verify that the appraised values were reflected by the partnerships as property-level financial information is not provided by all general partners.
- Appraisals are completed throughout the fiscal year; however there is no process in place to evaluate the changes in fair value from the appraisal date to CalPERS' fiscal year-end.

CalPERS should enhance the current processes by employing the following recommendations:

1. Assign the appropriate number of personnel to verify that appraised property values are recorded by the partnerships.
2. Require separate account general partners to provide financial information at the underlying property level to facilitate the appraisal verification process.
3. For separate account real estate partnerships that were not appraised as of CalPERS' fiscal year-end, review the partnerships' June 30 financial information to ensure significant changes in fair value are properly reflected in the partnerships' June 30 financial statements.

Management's Response:

IN PROGRESS. The Investment Office (INVO) concurs with the MGO recommendations and will enhance the following current processes:

1. At this point, INVO has completed the reconciliation process of all appraisals completed in fiscal year 2009-10 with the detailed financial statements provided by our real estate partners.
2. The new Automated Real Estate Information System (AREIS) provides the structure for reporting the financial information at the underlying property level. Although the Real Estate general partners have the ability to report at the property level, not all partners are contractually required to do so.
3. The INVO, Operations, Performance and Technology Division has recently instituted a new process where they now value CalPERS interests (required by the Appraisal of CalPERS Interests Policy) no more than six (6) months prior to June 30 of every year. This allows for no appraisal value of CalPERS interests to be more than six months old when provided as part of the year end financials.

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Observation 5: Accounting and Reporting Unitized Investments

Division responsible: Fiscal Services

Observation:

We observed that internally pooled (unitized) investments are allocated to participating funds based on the net asset value (NAV) of the unitized portfolios. NAV is equivalent to the price per share of the internal pool and reflects the fair value of the underlying investments adjusted for related investment receivables and payables. Reporting unitized investments at NAV may result in the misclassification of investment fair values and the related investment receivables, payables, income and expenses transactions.

We recommend that Fiscal Services Division, Investment Accounting Unit, separately allocate the fair value of unitized investments, receivables and payables for financial reporting purposes. Each fund's share of the fair value of unitized investments should be reported as part of the appropriate asset class. The allocated receivables and payables should be reported within the respective asset and liability line items in the financial statements.

Management's Response:

COMPLETE. Pending final approval from Macias Gini & O'Connell. Fiscal Services received concurrence from Macias, Gini & O'Connell on Fiscal's position to work with State Street Bank to develop an automated process for FY 2010-11. The automated process will separately calculate the ownership percentages for PERF and affiliate funds and reconcile the pool owner activity with the investment fund activity at the general ledger level.

Observation 6: Evaluation of Accounting Issues and Unique Transactions

Division responsible: Fiscal Services

Observation:

During our audit, we identified material loans and investment purchases associated with the Federal Reserve's Term Asset-Backed Security Loan Facilities (TALF) Program that were not properly recorded. Current accounting practices do not prescribe specific procedures to identify, research and document unique transactions and accounting issues. As a result, there were inefficiencies in the audit process and material adjustments to the financial statements.

We recommend that Fiscal Services should work with other Divisions and Branches within CalPERS to establish a process for identifying and properly accounting for new or unique transactions. The process should include formal documentation of the issue, pertinent background information, relevant legal and/or accounting guidance and the conclusions reached. The documentation should be prepared by staff with sufficient experience and reviewed by appropriate management personnel. Formal documentation will reduce staff and audit inefficiencies and ensure that transactions are properly and consistently reported in the financial statements.

Management's Response:

IN PROGRESS. Fiscal Services continues to monitor the GASB website for any new pronouncements and communicate with Investment Accounting and Investment Office staff

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to identify any new types of investment vehicles being used. To date, no unique financial activities have been reported to Fiscal Services and no new accounting and/or financial reporting pronouncements have been issued by the GASB or the GFOA. Fiscal Services will develop a plan of implementation for any new pronouncements or unique accounting activity and will implement new accounting and/or financial reporting practices. Target completion date is October 2010.

Observation 7: Implementation of New Accounting and Financial Reporting Standards
Division responsible: Fiscal Services

Observation:

The System is required to implement GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* and Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* for the fiscal year ended June 30, 2010.

GASB Statement No. 51 defines intangible asset as an asset that lacks physical substance, is non-financial in nature, and has an initial useful life extending beyond a single reporting period. The standard requires that qualifying intangible assets such as computer software, be reported as capital assets, and provides specific guidance on recognizing internally generated computer software. Accounting for the costs associated with the Pension System Resumption (PSR) and other projects should be evaluated in accordance with GASB Statement No. 51, and CalPERS should establish policies for the capitalization and depreciation of intangible assets, as applicable.

GASB Statement No. 53 provides guidance regarding the accounting and reporting of derivative instruments, including hedge transactions. Changes in the fair value of hedging derivative instruments will be reported as deferrals in the statement of plan net assets. Changes in the fair value of derivative instruments that do not meet the criteria for an effective hedge or are associated with investments that are already reported at fair value are recognized as investment income in the current period reporting. CalPERS will need to determine the nature and extent of derivative investments to properly apply the provisions of GASB Statement No. 53.

We recommend that CalPERS develop a work plan for the implementation of new accounting and financial reporting standards. An effective work plan should include the following essential elements:

- assign staff with sufficient experience to evaluate the new standards and determine the applicability to CalPERS,
- identify key personnel and data needed for the implementation,
- establish a timeline for the implementation,
- provide training to key personnel throughout CalPERS,
- apply the new standards to interim data,
- document the relevant provisions and the conclusions reached in a formal memorandum, and
- draft revisions to the financial statements for management's and the external auditor's review.

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Management's Response:

IN PROGRESS. For GASB 51, Fiscal Services has finalized the policy for intangible asset capitalization and relevant general ledger accounts have been established.

For GASB 53, Fiscal Services is drafting the position memo for Macias, Gini & O'Connell, along with note disclosures. Fiscal Services will finalize the position memo and disclosure notes and meet with Macias, Gini, and O'Connell to discuss the position memo. Target completion date is October 2010.